

Talbot Financial – First Quarter 2023 Review

Please find attached your Talbot Financial first quarter 2023 portfolio review to supplement your monthly account statements available from Schwab. The report provides a performance summary of your investment portfolio compared to the S&P 500 Total Return Index (“Index”), Talbot Financial’s benchmark, and lists your investment portfolio holdings by industry sector.

Investment Review

The year began with investors focused on the Federal Reserve’s aggressive policy to further increase interest rates to slow inflation. Then in early March a new issue surfaced when a liquidity crisis led to the collapse of Silicon Valley Bank. Despite these events, the stock market demonstrated its resilience as the Index increased 7.5% during the first quarter.

Performance for the quarter was led by the technology sector, which increased 21.8%. We attribute the outperformance of the sector to two primary reasons. First, the fallout from the regional banking crisis led to a flight to companies with high quality balance sheets, a characteristic shared by several large technology companies. Second, and more important over the long run, the realization that the industry is again at the forefront of a significant technological advancement in the form of Generative Artificial Intelligence (AI). At a recent software developer meeting, the CEO of Nvidia, Jensen Huang, stated that “this is the iPhone moment of artificial intelligence.” As part of our longstanding investment thesis on the industry, your Talbot Financial investment portfolio has a material allocation to the companies providing the building blocks and gateway to this technology, including Microsoft, Alphabet (Google’s parent company), Amazon, Nvidia, Adobe and Cisco. As Generative AI is in its infancy, we will have more to share on its continued evolution in the coming quarters and years.

We believe the recent rebound in the stock market was due to the belief that both inflation and banking concerns are shorter-term in nature. Specific to inflation and rate increases, over the last year the Federal Reserve raised the target Federal Funds Rate from 0.25% to 4.75%. The downward trend since the peak in June 2022 of the Consumer Price Index (CPI), a measure of inflation, suggests the rate increases were effective. In fact, when the shelter component of CPI is excluded from the calculation, the core components of CPI have returned to near historic average levels. Our view is that inflation will continue to fall and rate increases are nearing an end.

The rapid rise in interest rates had an unintended consequence on a small number of regional banks that experienced significant outflows of deposits. The issue was that some banks had not adequately matched assets and liabilities; and therefore, did not have the liquidity to cover the “run on the bank” by depositors. As such, Silicon Valley Bank and a couple of other banks became insolvent. Importantly, the risks were isolated to just a few banks with poorly managed balance sheets. The Federal Reserve and bank regulators also stepped in to immediately provide liquidity to the banking industry to stem potential further issues. As a result of the swift action by the government, a systemic risk to the banking industry was resolved.

Specific to the investment portfolio, we manage a watchlist of stocks we would like to own, but only when they meet our investment criterion. An opportunity arose in the quarter, and we initiated a new position in shares of Eli Lilly (ticker symbol: LLY), a pharmaceutical company.

Lilly, like its peer companies, invests a significant amount of its research and development budget into a pipeline of future drugs, all of which are at various stages of development. Lilly has the following two drugs close to commercialization:

- Mounjaro, recently approved for treatment of type 2 diabetes, is currently part of the Food & Drug Administration's fast-track review program for obesity. In recent trials, the drug resulted in an over 22% weight loss in adults with obesity, a greater percentage of weight loss than comparable drugs currently on the market. Given the fast-track authorization and drugs with similar biochemistry already on the market, the odds of approval are favorable. Industry analysts forecast Mounjaro has the potential to generate upwards of \$20 billion a year in sales.
- Donanemab, which is in testing to reduce the effects of Alzheimer's disease, is nearing the end of stage 3 trials. Preliminary indications are that it may provide higher efficacy than other treatment drugs in reducing amyloid plaques to the brain. We expect the drug to receive approval in late 2023 or early 2024. If approved, the forecast is it could generate over \$10 billion a year in sales.

Lilly is already an industry leader and in strong financial condition, and going forward has the potential to produce and distribute two of the highest selling drugs of all-time. We will be monitoring.

We welcome the opportunity to review your portfolio in person, by phone or on a Zoom conference. Please feel free to contact us for a review, or to answer any questions you may have about your portfolio.

Sincerely,

Talbot Financial, LLC

www.talbotfinancial.com